DOW THEORY LETTERS INC.

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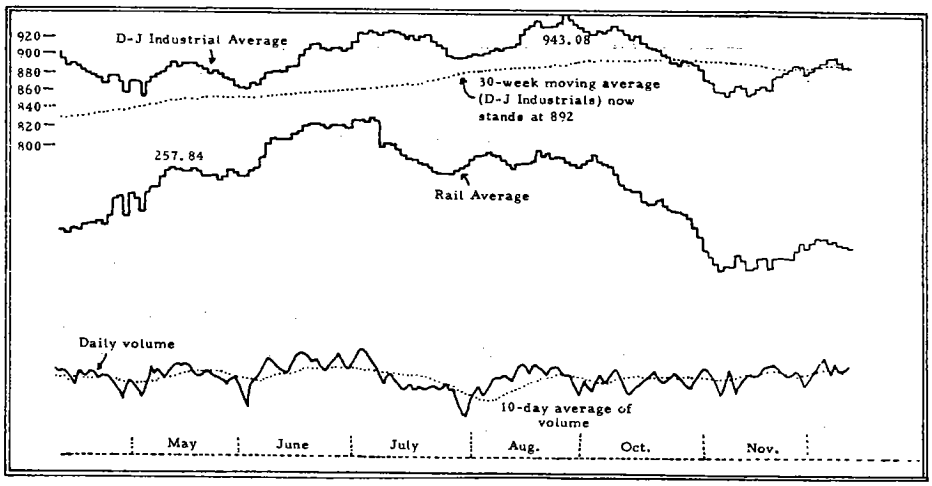
THE MARKET: Market students can almost write off the month of December as an important "trend-setting" month. Except for the latter part of December, 1966, the records of the past 25 years show that December almost always produces a sideways or rising market (and this is particularly true of the last two weeks of December). Therefore, rally or not (and a rally is always more probable), I suggest that we look to January for the first signs of a reassertion of the primary bear trend.

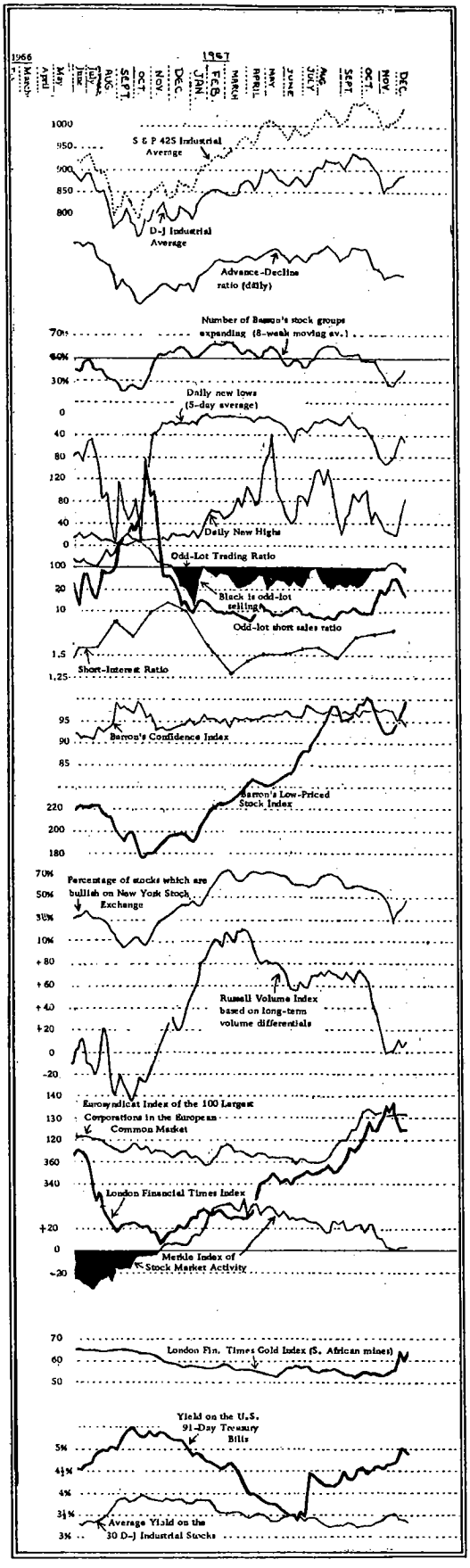
One thing which I call attention to (and I was interested to see that Humphrey Neill of "Contrary Opinion" fame brought this out in his latest report) is the "everything's all right" attitude now so universally expressed regarding the pound sterling and the dollar. The consensus is that the pound has been adjusted satisfactorily, and that now a new bull market can run on its merry way. I sincerely doubt this thesis.

If subscribers will turn back to their December 6 report, I will quote from this Letter by my cohort, Mr. Holzman: "As a matter of fact, for those subscribers who like to speculate, I would say that selling short on sterling futures might not be such a bad idea. The British trade figures for the first quarter, 1968, are probably going to look very bad, and that should hit the pound hard."

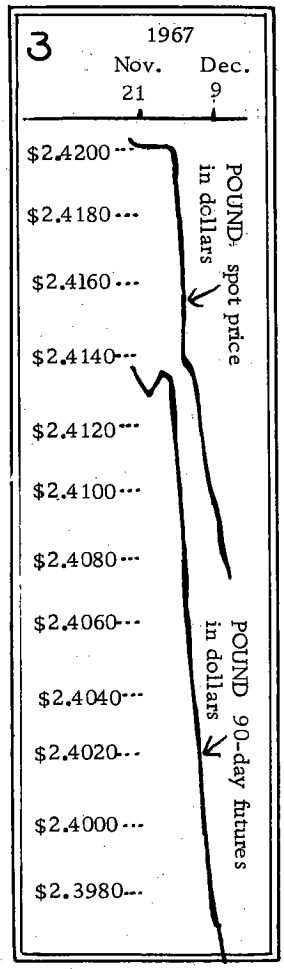
Despite the euphoria which has blanketed the financial world, I prefer to look where I always look — at the facts. On page 2 I have reproduced my chart of the pound, and I show the price of the pound spot and the pound 90-day futures since the devaluation. The trend is distressingly obvious. The British Government allows the pound to fluctuate around 1% above or below part (which is now $2.40), and already the futures have broken par. The spots are heading towards par rapidly. By late-January or February the pressure on the new pound could again be intense.

As a sign of the times, we joke at this office about our "resignation index" which is now breaking out on the upside. The index is a tabulation of high-level resignations in the inflation-bent nations (U.S. and Britain). So far recent statistics




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

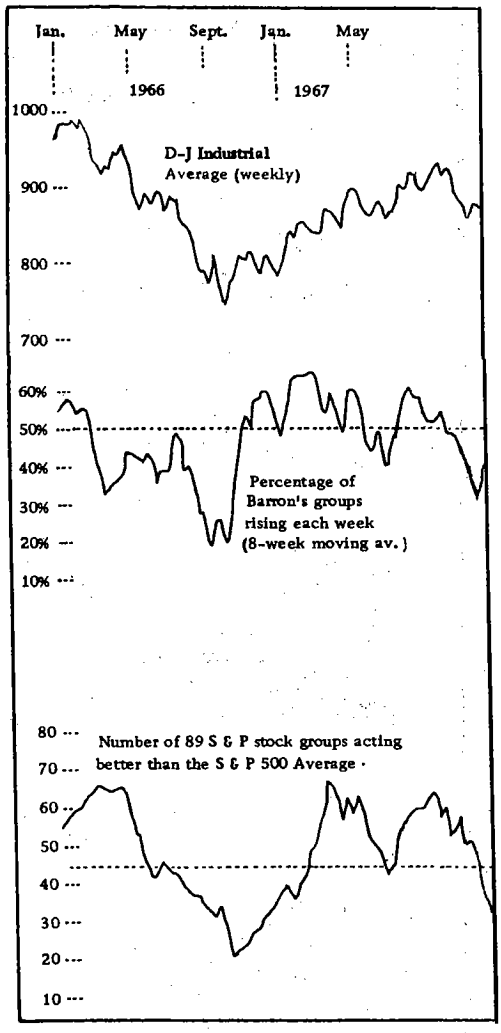
show British Finance Minister Callaghan and U.S. Secretary of Defense MacNamara out, while U.N. Ambassador Goldberg and Secretary of the Treasury Fowler are in the wings.



On Wall Street the rally which began in mid-November seems to have passed its peak of strength. "Normal" bullish December pressures seem to be bolstering the market, but since last week we have seen an increasing number of divergences and faltering days in the market. On Friday, December 8, American Telephone broke to a new 1967 low of 49 3/4, which matches the 1966 low (as I predicted it would in Letter 375—see chart in that Letter). Anything under 49 3/4 would take Telephone back to its lowest level since 1962. Since this is the most widely distributed stock in the world, the precarious position of Telephone must be considered a bearish omen for the market.

I must again call attention to the sluggish performance of the Rail Average on the rally. The carriers have so far recovered only 26% of their August-November losses against 46% for Industrials. I would expect the Rails to continue this lagging characteristic for the greater part of the bear market. A study of past major bear markets indicates that Rails tend to lag on the upside (during counter-primary trend rallies) and lead on the downside (when the primary bear forces assert themselves).

Referring to the page 1 composite chart, the Russell Volume Index is forming a little triangle, having dropped to minus 1 at the low and plus 13 at the rally high. The latest reading is plus 10. This index is tabulated by subtracting the 60-day plus volume from the 60-day minus volume of all stocks on the N.Y.S.E. It is worth noting that on the latest tabulation, minus volume has risen to an all-time high but plus volume is still 10 points above minus volume. In other words, on the rally selling volume has continued to expand while buying volume has also expanded. But the implication is that any selling would quickly take plus volume below minus volume, with minus volume continuing to rise to new all-time highs. A much more bullish situation during the rally would have been a climb in plus volume with a decline in minus volume. This did not occur.



Barron's Confidence Index broke last week to 94.7, its lowest level since last February. In the face of this caution among bond buyers, Barron's Low Priced Stock Index (refer to composite chart) rose to 320—almost its 1967 high. Odd-lotters, reflecting normal year-end selling, have now switched to the selling side. The Gold Index of South African shares has risen to 63, just 2 points under its high for the past year. This index has now formed an excellent base, and I again recommend the purchase of American Depository Receipts in such issues as President Brand, Blyvoors, Western Deep Levels and President Steyn.

My studies of stock group action (page 2) show a decided lack of strength on this rally. The 8-week moving average of stock groups expanding has risen from a November 17 low of 27% expanding to last week's high of 40% expanding. This is still well below the critical 50% level (see attached chart). At the same time, Chartcraft's tabulations of the number of 89 Standard & Poor's stock groups acting better than the 500 Stock Average has dropped to a new low of 29—and this again shows a definite lack of strength from the group standpoint.

REVIEW: For new subscribers and for the benefit of older subscribers, I want again to review this market from the long-term standpoint as I see it. Dow Theory tells us to be more or less fully invested during primary bull markets and relatively liquid during bear markets. To do otherwise is at best risky investment procedure, since the primary trend will ultimately take almost all stocks along in its tide.

The bull market which began in 1949 ended in February, 1966, at 995.15 on the Dow. The first phase of the bear market ended in October, 1966, at the 744.32 lows. Historically, the first phase of a bear market is the phase wherein stocks sell minus hopes and expectations. During the first phase of this bear market, many blue-chip and glamour stocks lost large percentages of their 1949-66 gains.

But no two bear markets (or bull markets) are alike. The beginning of the second phase of this bear market was extremely deceptive. It was deceptive because during the 1966-67 recovery speculation was rampant; it was as intense as anything seen in the past decade, and many glamour stocks and low-priced issues rose to new highs during the 1966-67 rally. Margin accounts and margin (debit) balances rose to historic highs, and for the only comparison with the 1966-67 action we must turn to 1930, at which time another great and deceptive rally occurred within the context of a primary bear market.

I place us now at about the middle of the second phase. The early disruptions, dislocations and emergencies which will ultimately topple the entire price structure are now becoming visible. Galloping inflation, British devaluation, a profits squeeze, intense foreign competition, a run on our gold, political upheavals, riots, civilian demoralization, high-level resignations, political deceit, strikes, all of these and more are laying the groundwork for things to come. When the effects of all these and more exert their full bearish force on the economy, the second phase will be in full force, obvious and there for all to see and feel. This phase is coming as sure as night follows day.

Those who have taken our advice and assumed an 80% to 85% position in Treasury bills with the remainder in gold shares are now beginning to reap some of the benefits of a sheltered and hedged position. The advantages of this position will be even more obvious as time goes by.

The third or final phase of the bear market will be marked by a decrease in speculation and exchange volume. Yields on common stocks will become very attractive again, but the stocks themselves will look "unattractive" because there will be a hundred reasons why "one should not touch them with a ten foot pole". But I warn readers to prepare for that time, because we are going to touch them—we are going to buy today's shares at perhaps 25% to 80% below their current listed values. That's what the Dow Theory teaches us; that times change and prices change, and that when prices are on the bottom and yields are high, that is the time for us to accumulate for the next great bull market. That is the time when the seeds of the next mighty fortunes will be sown. But the tools are cash, and courage, and we hope all our subscribers have both when they are needed. I can help you conserve the first, and I might be able to generate a bit of the second. But remember, in the end the decision to follow Dow Theory must be made by you. This is the time to do it—now. Not when it is too late and all that I write here is fact.

I have many subscribers who hold Dome Mines purchased below 20. I have subscribers who own American-South African in the 20's. They have doubled and in some cases tripled their money in a fundamental position which I believed was relatively safe. Dome looks more attractive at 55 now than it did at 17 back in 1959 (when I first recommended it). Dome will probably look "better" at 100 in 1968 or 1969 than it does now at 55. The rise in the gold shares is the market's attempt to discount the fall of the dollar, and those who saw the trend of events clearly are now holding paper profits as the world moves to get out of paper dollars. It is never pleasant to see a great currency fall, but it happens—perhaps once a generation.

When the present mess expresses itself fully, when stocks are low and have discounted the worst which is likely to occur, then events can only turn brighter and things can only get better. All this I feel we will see during the next two or three years. They will be exciting times for those who have played their cards right—and disastrous times for those who follow the crowd, the newspapers and the political leaders.

QUOTES AND NOTES: Humphrey Neill's December 6 report: "I get the feeling that 'everybody' (except perhaps contrarians) thinks a great crisis has been successfully dealt with; as if they were saying, in effect, 'let's get on with the bull market; business is going to be on the up-and-up next year; there's bound to be more inflation; the dollar's safe, so what are we waiting for?' "

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From the New York Times, Dec. 4: "William Hummer, a partner of Wayne Hummer & Co., Chicago, has recently returned from Europe and he reports that top people there say there is absolutely no possibility that European nations will agree to initiate scheduled special drawing rights to a new international currency in 1969 unless the United States manages to chop its balance-of-payments deficit in half—to below $1 billion a year.

"Further, they believe the situation is so tense already that the United States will find it necessary to make more restrictive the controls on the outflow of United States dollars soon."

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From the Dec. 6 Janeway Report by Eliot Janeway: "Bond Market Bottom. It's still a good way off—both market-wise and time-wise. Arrogance and ineptitude characterized the Administration's high-pressure campaign to put House Ways and Means Committee Chariman Mills on the spot in the newspapers." Later, Janeway states, "Meanwhile, back in London suspicion of sterling is more acute than before the run knocked the dollar prop out from under it. Consequently, pressure is starting to build up against it all over again. Weakness is infectious....."

 The latest Federal Reserve Gold Ratio was 28.5, just 3.5% from the statuatory limit of 25%. This is at what I consider the crisis level, and we will probably shortly hear of emergency legislation to remove the remaining gold backing for all currency. Thus, all remaining gold ($12.8 billion) would be earmarked against foreign claims (which amount to $30 billion) against the dollar. The figures are growing steadily more ominous— and foreign central bankers are growing steadily more nervous. From here on, the profligate U.S. Administration will be acting from fear and a defensive position—while the once-mighty U.S. dollar becomes a fiat currency.

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The latest Bolton Tremblay report makes a most convincing case for a coming doubling ortripling in the price of gold. "The greatest problem facing the U.S. Treasury today is that people like gold. Just as women love sable. And as many male readers know too well, wives are never harder to restrain than when sable is on sale. And foreign people who notice that gold is on sale and are free to buy it have the same irresistable urge." Later, the report sums up the situation most neatly in the following two sentences: "The alternatives to the elaborate temporizing that is becoming so increasingly difficult are only two in number. Either a convincing correction of the balance of payments problem or a substantial increase in the price of gold."

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From Joseph Granville's Dec. 8 report: "Whether we like it or not, we are on the road to devaluation and it is very difficult once that trip is embarked upon to get onto a different road. There is no austerity program in America today. We are on this road toward devaluation and yet everybody wants more of everything and grumbles when they have to pay for it. Not a day goes by but what the U.S. dollar gets another kick in the teeth and the biggest kicker is Uncle Sam himself. Just in the last few days we have read about pay boosts for the armed forces, pay boosts for mail carriers, gigantic boosts in Social Security, more pet Administration projects costing new billions and the very latest is the round of steel price increases."

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On December 12 a renewed attack on the dollar hit Paris, London and Zurich with the dollar price of gold rising to a new high of $35.21. Obviously, the higher the price of gold the lower the price of dollars or the more dollars required to purchase a given quantity of gold. I can only warn readers that where there is smoke, there is fire. And the smoke is getting thicker month by month. If the U.S. decides to embargo gold, it will throw gold on the free market. If this occurs, the price of gold could jump to perhaps $50 or $70 per ounce.

Most people do not realize that the reason for the gold speculation overseas is simply that gold buying is not legal here. If it was, sophisticated investors would probably clean out Fort Knox within a matter of months.

* * * *

Secretary of Defense McNamara went out quietly, issuing no statements worth quoting or pondering. The general belief is that McNamara and LBJ did not agree on the war. In my opinion, the jettisoning of McNamara almost certainly means a step-up in the pace of the war. McNamara was known as the only real dove within the top echelons of the Administration.

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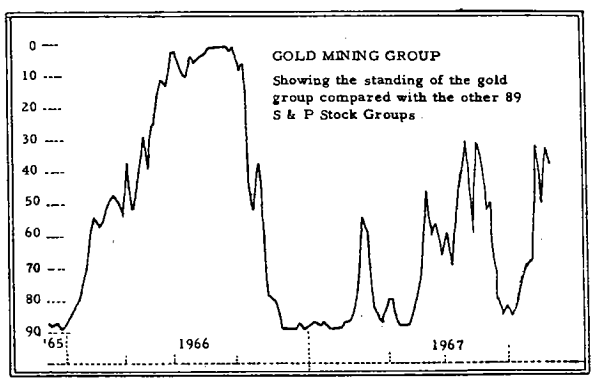
On December 12 civil war broke out in Greece, and the implications here are serious. If the war assumes large-scale proportions (and there is a good chance that it will), then it will provide another opportunity for communist intervention and take over. If this happens, Washington will have almost as much reason to move troops into Greece as it did when it moved armies into Vietnam. In Letter 357 (April 10, 1967), I mentioned the probability that the Communists could open another front in Greece. We should know in a short while whether the Greek civil war is to expand and whether the Communists will, in fact, use Greece as a sort of "new Vietnam." If they do, we can expect consternation and confusion out of Washington. But would Washington "allow" Greece to go communist?

MOVING: In November France increased her gold supply by over $300 million while the U.S. lost near $500 million. France's dollar holdings also climbed to around $1 billion, and since France usually keeps only about half that amount for working balances, this allows for the possibility of steady new French dollar exchanges for gold. The precariousness of this situation is reflected in my chart of the standing of the Gold Mining Group of stocks (compared with the other 89 Standard & Poor stock groups).



Note that since late-1966 this gold group standing has built a series of rising bottoms, the first at 89 in late-1966, the second at 85 in early 1967 and the last at 85 in October, 1967. The gold group has now formed a powerful base with resistance at the 33 level. Should the group standing move to 32 or less in the next few weeks, we would have the makings of a poweful and concerted rise in the gold shares.